IN THE

Supreme Court of the United States

October Term, 1946.

No. 847.

The United States, *Petitioner*,

v.

The Munsey Trust Company of Washington, D. C., *Receiver*.

On Petition for a Writ of Certiorari to the Court of Claims.

BRIEF FOR RESPONDENT

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CITATIONS.

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BRIEF FOR RESPONDENT.

Opinion Below.

The opinion of the Court of Claims (R. 17-28) is reported in 67 F. Supp. 976.

Jurisdiction.

Petitioner has invoked the jurisdiction of this Court under Section 3 (b) of the Act of February 13, 1925, as amended. The judgment of the Court of Claims was entered on October 7, 1946. (R. 28)

Question Presented.

After a contractor has breached its contract and bond by failing to pay labor and material claims and the surety upon its bond has remedied the breach by paying such claims, may the United States appropriate the contract balances for the payment of their own independent claims, unrelated to the contract and bond, arising out of transactions entered into subsequently and thereby preclude the application of those contract balances to the losses which the surety suffered?

Statement.

In addition to the statement made by petitioner, it should be pointed out that the transaction out of which the independent claim of the United States arose, was entered into subsequent to the giving of the bonds under which the surety responded. It should also be noted that a $415 bid deposit was taken by the United States as security for the proposed $20,743 contract in connection with which their independent claim has arisen. (R. 15) It is obvious that a deposit of this amount is grossly disproportionate to the amount of the proposed contract and inadequate to protect the United States from the hazard incurred.

BRIEF.

The Decision Below is Correct.

This Court held in a case involving a similar contract and bond, *Martin* v. *National Surety Company*, 300 U. S. 588, that:

> "The terms of the bond are read into the contract, and there is default under the contract when there is default under the bond."

As a consequence of the contractor's failure to pay labor and material bills it necessarily forfeited its rights to receive payment under the contracts involved here. Where

the contractor breaches its contract by failing to complete the work, or to pay the labor and material claims, the accumulated balance of the contract in the hands of the Government constitutes a fund which is available for remedying the damage which results. In other cases the Government appears to have contended without success that it could require the completion of the work by the surety, and then appropriate the contract balance in the extinguishment of unrelated claims against the contractor. *United States Fidelity & Guaranty Co.* v. *U. S.*, 92 C. Cls. 144. No more reason exists why the surety should be required to pay claims for the labor and material which created the finished work while the United States are thereafter permitted to appropriate the contract balances for the payment of claims which arose out of transactions entered into subsequently and with which the surety had no connection or obligation.

The United States have required by the terms of the Miller Act, Act of August 25, 1935, 49 Stat. 794, 40 U. S. C. A., 270 a-d, that the contractor give bond with surety as a condition precedent to the making of the contract.

> "Before any contract exceeding $2,000 in amount for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, * * *
>
> (1) A performance bond with a surety or sureties * * *.
>
> (2) A payment bond with a surety or sureties * * * for the protection of all persons supplying labor and material in the prosecution of the work * * *."
> Title 40 U. S. C. A., 270(a)

The contract and the bond create a contractual relation between the Government, the contractor and the surety. It is inescapable that there results an obligation on the part of the Government not to defeat the expectation of the parties and the obvious intendment of the contract, by diverting the contract proceeds so that they cannot be used for the

construction of the work and the payment of labor and material bills. If the United States were permitted to divert the final contract balances, they will be equally free to divert every installment of the contract payments commencing with the first, thus creating a liability far beyond anything which could have been intended when the bonds were given.

Petitioner argues (Petition pp. 8-9) that the labor and material furnishers have no legally binding claim against the United States and that as a consequence the surety could have none. But there is no claim here that the United States must reimburse the surety for the claims which it pays. It is only the contract proceeds which are the subject of the controversy. The judgment of the Court below did not fully reimburse the surety (R. 16-17), nor did the surety make claim to the proceeds of any contract in excess of the loss which it had incurred under that contract. (R. 17)

If persons furnishing labor and material for the construction of public works do not have a legally binding claim against the United States, they have a claim which this Court has recognized as a moral claim. *Henningsen v. United States Fidelity & Guaranty Company*, 208 U. S. 404. Such claims have been recognized even before the passage of the original Heard Act, Act of August 13, 1894, 28 Stat. 278, 40 U. S. C. A. 270 (Petition pp. 18-20), *Greenville Savings Bank v. Lawrence*, 76 Fed. 545. The courts have repeatedly held that the surety, upon responding to claims made on its bonds, either for performance or the payment of labor and material, becomes subrogated to the rights of the United States. It was said in a case where a surety sought to recover the proceeds of such a contract from a third party, that:

> "Thus, in consequence of Anderson's (contractor's) default, the $37,170.04 then in the hands of the United States became a fund which the United States was entitled to apply to the payment of the materialmen's claims, and which appellee, as subrogee of the United States, was entitled to have applied in reimbursement

of the $21,609.28 expended by it in paying such claims; and appellee's right to have the fund so applied was superior to any right of Anderson or Anderson's assignees—if any." (parenthetical expression added) *California Bank* v. *U. S. F. & G. Co.*, 129 F. (2d) 751 (C. C. A. 9th).

(See also *Hardaway* v. *National Surety Company*, 211 U. S. 552; *In re Scofield Co.*, 215 Fed. 45 (C. C. A. 2d); *American Bonding Company* v. *Central Trust Co.*, 240 Fed. 400 (C. C. A. 7th.)

In *Belknap Hardware Mfg. Co.* v. *Ohio River, etc., Company*, 271 Fed. 144 (C. C. A. 6th) it was said with reference to *Henningsen* v. *United States Fidelity & Guaranty Company*, 208 U. S. 407:

> "Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated. This is not stated in the opinion in very express terms, but it had been pressed upon the Court (208 U. S. 407, 408; 28 Sup. Ct. 389, 52 L. Ed. 547) that there could be no such subrogation without such a right, and that there was no such right. On page 410, of 208 U. S., on page 391 of 28 Supreme Court (52 L. Ed. 547), the Court refers to and assumes that the Government, after the bond was given was still charged with 'equitable obligations to see that the laborers and supplymen were paid.' We are constrained to think that the decision necessarily rests upon the existence of this right as one entitling these claimants to priority in payment out of the fund, and therefore as entitling the surety, as their equitable assignee by subrogation, to the same priority."

Petitioner's argument seems to admit that the surety's right to the contract proceeds is superior to that of any claimant other than the United States. Indeed the General

Accounting Office paid over to the respondent all of the contract balances which it did not appropriate to extinguish the contractor's independent indebtedness (R. 16). That Office has recognized the surety's rights in the past. 8 Comp. Gen. 435, 8 Comp. Gen. 58.

The Government argues that all of the claims of the United States had not been satisfied citing *United States* v. *National Surety Co.*, 254 U. S. 73 (Petition p. 11). The doctrine of that case has no application here. That was a case where the bond secured only a part of the very loss on account of which the Government claimed. The surety paid the penalty of its bond, but that did not satisfy the debt. The surety was denied the right of parity with the Government since the very debt secured remained partially unpaid. In the case at bar the obligations secured have been paid in full and nothing further remains due. The claim of the United States springs from a totally foreign transaction. The effort of the Government to extend the rule of *United States* v. *National Surety Co.* to the case at bar would result in requiring the surety to pay other debts of the contractor which it had never undertaken to secure. *Maryland Casualty Co.* v. *U. S.*, 100 C. Cls. 513.

The Government's claimed right of set-off in circumstances such as those here involved has not been established by any settled line of administrative practice. In fact, the action of the General Accounting Office proceeds upon an administrative rule that all doubtful cases should be decided in favor of the Government, leaving the claimant to pursue his remedy in the courts. That office recognizes the controversial character of such questions as these and that the courts are the proper forum for their determination. Decisions of the General Accounting Office guided by such a standard cannot form precedents and lend no aid to courts in their decision of controversies.[1] In addition to

[1] The reasons for this are that the General Accounting Office functions as a court of last resort so far as the Government is concerned, its decisions in that respect being by law conclusive upon

this, the function of the General Accounting Office is no more than that of an accountant or auditor. The decisions made there are administrative only, *Illinois Surety Company* v. *United States to the use of Peeler*, 240 U. S. 214, and are always subject to judicial review. Not only did the decision of the General Accounting Office in this case (R. 20-21) run counter to the decisions of the Federal courts generally, but it is admittedly in head on conflict with the determinations made in the very court set up to hear controversies between the Government and its citizens. (R. 20)

The right which the United States enjoy to liquidate their own claims out of funds of a debtor held in their hands is not, strictly speaking, a right of set-off. That term is generally understood to include only such rights as have been accorded by statute. No such statutory right has ever been granted to the United States. The United States have followed a practice arriving at a result substantially the same as that obtained under ordinary statutes of set-off. The right of withholding by the United States, however, has been said to be:

> "* * * but the exercise of the common right which belongs to every creditor, to apply the unappropriated monies of his debtor, in his hands, in extinguishment of the debts due to him." *Gratiot* v. *United States*, 15 Pet. 336.

The only provision in the Federal statutes expressly relating to set-off by the United States is found in Title 31 U. S. C. A. Section 227, Act of March 3, 1875, 18 Stat. 481, authorizing the Comptroller General to withhold the payment of

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the executive branch of the Government. *Skinner & Eddy Corporation* v. *McCarl*, 275 U. S. 1, 4-5 footnote. There is no provision for appeal to the courts from such decisions where they run against the Government. But where the claim is disallowed the claimant is free to appeal to the court for a review of the decision. *Savings Bank of Pittsburgh* v. *United States*, 16 C. Cls. 335, 351. Probably a large portion of the decisions of the Court of Claims involve review of settlements of the General Accounting Office.

final judgments in any instance where the United States have a claim against a judgment creditor, and providing further that the United States shall be required promptly to institute suit upon their own claim. That statute has no application here.

It is characteristic of set-off that the claims which are to be balanced against one another must be mutual. This is demonstrated by *Gray v. Rollo,* 18 Wall. 629. There a bankrupt insurance company was the holder of notes signed by one Gray. Gray was also a member of a partnership to which the insurance company was indebted upon insurance policies. When an effort was made on behalf of the insurance company to collect upon Gray's notes, he defended and endeavored to set off the claims of his partnership upon the insurance policies. His defense of set-off was denied because of the lack of mutuality of the balancing credits. It was said:

> "The insurance company, so far as appears, took the notes without any reference to the policies of insurance; and Gray Brothers insured with the company without any reference to the notes. Neither transaction was entered into in consequence of or in reliance on the other; and no agreement was ever made between the parties that one claim should stand against the other."

The reasoning of this case is particularly applicable to the facts in the case at bar, since in the case at bar the surety stands as a third party, having a well recognized interest in the proceeds of the contract.[2]

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[2] *Cherry Cotton Mills Inc.* v. *United States*, 327 U. S. 536, cited by petitioner is not in point here. That case involved the situation of a debtor atempting to escape the payment of an admitted obligation to the R. F. C. through the purely procedural objection that such a debt was not a proper set-off in the Court of Claims. The question here presented is a question of substantive law, namely, whether the United States can in effect require a surety to pay debts of its principal by appropriating contract funds which the surety has created as a consequence of its having paid for labor and material used in the performance of public work.

The Conflict Between the Decisions of the Court of Claims and the Policy of the General Accounting Office.

Petitioner's brief refers to a practice of the General Accounting Office in setting off "mutual claims"[3] in situations such as that presented here. It is the information of counsel that such situations have arisen but rarely in past years, although it now appears that they are arising more frequently and may continue to arise with even greater frequency.[4] It is also proper to point out that the General Accounting Office has expressed an intention of declining to follow the decisions of the Court of Claims dealing with this subject until this Court shall have passed on the question. (R. 20-21, 8-11) It is the information of counsel that the General Accounting Office intends to adhere to this course.

Since the General Accounting Office denies a surety paying labor and material claims reimbursement from the contract funds if the United States have unrelated claims of any kind against the contractor, the surety is obliged in such instances, to prosecute a suit through the Court of Claims, with the expense and consumption of time necessarily involved.

Inasmuch as that court, as in this case, has upheld the right of the surety to such reimbursement, *Maryland Casualty Co.* v. *U. S.*, 100 C. Cls. 513, the result is continuous litigation over the identical legal question, a situation which appears to be no more satisfactory to the Government than to the sureties who are obliged to sue.

Respectfully submitted,

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[3] It has been pointed out (supra p. 8) that the claims are not mutual.

[4] The case of *Seaboard Surety Co.* v. *United States*, 67 F. Supp. 969 (C. Cls.) cited by the petitioner is the subject of a pending application for certiorari, No. 846, October Term, 1946.